ST 00-13
Tax Type: Sales Tax
Issue: Audit Methodologies and/or Other Computational Issues
Books and Records Insufficient
Unreported/Underreported Receipts (Fraud Application)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS	)	Case No. 98 ST 0000
	)	IBT No. 0000-0000
v.	)	NTL SF 199800000000000
	)	
"GOBSTOMPERS, INC.",	)	Administrative Law Judge
Taxpayer	)	Mary Gilhooly Japlon

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Mark Dyckman on behalf of the Illinois Department of Revenue; Michael A. Cotteleer on behalf of "Gobstompers, Inc."

SYNOPSIS:

This matter came on for hearing pursuant to the timely protest by "Gobstompers, Inc.", (hereinafter "GI" or "taxpayer") of Notice of Tax Liability (hereinafter "NTL") No. SF-199800000000000 issued by the Department of Revenue (hereinafter "Department") on June 17, 1998 in the amount of $60,954 for Retailers' Occupation Tax (hereinafter "ROT") for the period of January 1995 through December 1997. At issue is whether the Department's audit, based on its "best judgment and information", meets the "minimum

standard of reasonableness" as required by law. Also at issue is whether the Department's assessment of the civil fraud penalty was proper.

At the hearing held on January 27, 2000, after the Department entered its prima facie case into evidence, several witnesses testified on behalf of the taxpayer: "Amy Madigan" (adverse witness), "Louise Fletcher", "Rube Goldberg", "Simon Legree" and "Jerry Mathers".

Upon consideration of all the evidence elicited in this case, it is recommended that the Notice of Tax Liability be affirmed, with an adjustment in tax, and corresponding penalty and interest, as determined by the Department. (Dept. Ex. No. 5). The fraud penalty is likewise affirmed, with an adjustment corresponding to the reduction in tax as determined by the Department.

FINDINGS OF FACT:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission into evidence of a certified copy of a Correction of Return, showing a liability due and owing under section 4 of the Retailers' Occupation Tax Act from "GI" in the amount of $34,881 for tax liability, late payment penalty in the amount of $5,232 and a fraud penalty of $17,441, for a total amount due of $57,554 for the taxable period of January 1, 1995 through December 31, 1997. (Dept. Ex. No. 1; Tr. pp. 11-12)
2. A civil fraud penalty in the amount of 50 percent of the tax liability was assessed for the entire audit period of January 1, 1995 through December 31, 1997. (Dept. Group Ex. No. 2; Tr. p. 12).

3. Revenue Auditor "Madigan's" audit narrative details the audit and audit results. (Dept. Ex. No. 3; Tr. p. 13).
4. The auditor's audit history is detailed in her EDC-5. (Dept. Ex. No. 4; Tr. p. 13).
5. An adjustment was made to the tax liability, resulting in a tax reduction of $2,238. (Dept. Ex. No. 5; Tr. p. 14).
6. The business known as "Gobstompers, Inc." is a tavern in a blue-collar neighborhood; the business sells mostly beer, but does not sell food. (Tr. pp. 17, 18, 19, 66).
7. During the revenue auditor's initial interview with "Simon Legree", owner of "GI", at the preliminary conference conducted at the Department of Revenue's Des Plaines office on October 21, 1997, she questioned him concerning the price of draft and bottled beer. (Tr. pp. 19, 20-21).
8. Based upon her physical inspection of the first floor of the tavern, as well as an examination of purchases, the auditor determined that the majority of sales consisted of draft beer sales, with bottled beer secondary, and minimal sales of hard liquor. (Taxpayer's Ex. No. 3; Dept. Ex. No. 3; Tr. p. 23).
9. Mr. "Legree" advised the auditor that draft beer sold at $1.50, and that there were "specials" during the week, such as $.25 drafts on Tuesdays, $.50 drafts on Wednesdays and Thursdays, $1.00 domestic bottled beer on Wednesdays and $1.50 on Thursdays. (Dept. Ex. No. 3; Tr. pp. 27-28, 45).
10. However, "Legree" did not give the auditor any documentary evidence in the form of books and records to support the amount sold at special prices, nor the length of time per day that the specials ran. (Tr. pp. 28, 30).

11. An EDC-5 is a diary of the audit; notes are taken by the auditor simultaneous with the discussion with the taxpayer. (Tr. pp. 45-46).
12. An EDC-5 was prepared in the instant audit; the auditor took notes during the course of the preliminary conference with the taxpayer. (Dept. Ex. No. 4; Tr. pp. 45-46).
13. The auditor made a physical inspection of the first floor of the tavern, but not the basement where the storeroom is located. (Tr. p. 22).
14. According to an examination of draft beer purchases, the purchase amounts decreased from 1995 through 1997. (Tr. p. 42).
15. "Legree" never gave the auditor a menu, price list, end of year inventory, or any documents associated with books and records reflecting the price of beer. (Tr. pp. 42-43, 44).
16. The taxpayer tendered no cash register tapes indicating sales totals, nor did he maintain daily sales journal or ledgers. (Tr. p. 43, 77).
17. Of the entire audit period, invoices were tendered for only three months. (Tr. pp. 43, 77).
18. Regarding purchases, the only information provided by "Legree" was a piece of paper containing suppliers' names. (Tr. p. 43).
19. Due to the lack of books and records in the instant case, the auditor had to rely on other available information in determining the liability. (Tr. p. 46).
20. In fact, three methods were considered; the purchase and mark-up method was the one employed. (Tr. pp. 30-31, 32, 46).

21. The auditor made a written request dated May 6, 1998 to her supervisor requesting authorization to impose the fraud penalty on the tax liability established over the entire audit period. (Dept. Ex. No. 2; Tr. p. 52).
22. Prior to receiving written approval of the fraud penalty on May 14, 1998, the auditor received verbal approval on March 25, 1998. (Tr. pp. 40, 52).
23. The auditor continued to ask "Legree" for books and records in order to complete her audit; she also asked him to keep and to maintain register tapes. (Tr. pp. 55, 56; Petitioner's Ex. No. 4).
24. The taxpayer paid his employees in cash from the cash drawer. (Tr. p. 49).
25. The amounts expended for payroll, therefore, were never deposited into a bank account. (Tr. p. 51).
26. Nor were the payroll amounts taken as a deduction on corporate returns. (Tr. p. 50).
27. When bank account deposits are added to estimated cash payroll, gross receipts total $227,099 in 1995 and $177,504 in 1996. (Tr. p. 51; Dept. Ex. No. 2).
28. The auditor's method of marking up purchases to selling price resulted in expected gross receipts of $218,415 in 1995 and $199,111 in 1996. (Dept. Ex. No. 2).
29. These figures as determined by the auditor are fairly close in amount to the figures derived from looking at bank deposits, plus cash payroll.
30. No bank account information was available for 1997. (Tr. pp. 51-52).
31. The percentage of underreported gross receipts comparing returns as originally filed with the amounts determined by the Department is 248% for 1995, 174% for 1996 and 234% for 1997. (Dept. Ex. No. 2).

32. When comparing gross receipts as reported on amended returns as filed with the amounts determined by the Department, the percentage of underreported gross receipts is 167% for 1995, 119% for 1996 and 170% for 1997. (Dept. Ex. No. 2).
33. During the audit period, more draft beer was sold than bottled beer. (Tr. p. 68).
34. During the audit period, "Legree" placed advertisements in the Illinois Entertainer advertising various bands booked to play at "GI", as well as draft and bottled beer specials. (Tr. p. 73; Taxpayer's Ex. No. 6).
35. Some of the ads indicate that beer on Tuesdays is $.25, on Wednesdays or Thursdays draft beer is $.50 and bottled beer is $1.00 or $1.50 on Thursdays. (Taxpayer's Ex. No. 6).
36. Many of the ads bear no printed date. (Taxpayer's Ex. No. 6).
37. The taxpayer did not provide the auditor with any evidence to indicate the amount of beer sold at the special prices. (Tr. p. 28).
38. The busiest nights at "GI" are Friday, Saturday and Tuesday. (Tr. p. 79).
39. The report drafted by the Certified Public Accountant retained by the taxpayer reflecting a tax liability of $4,952 was prepared without any books and records from taxpayer. (Tr. p. 80; Petitioner's Ex. No. 5).
40. Rather, the report utilized the auditor's methodology, using information from distributor summaries, Illinois Entertainer ads and Mr. "Legree" himself. (Tr. pp. 80, 81).

CONCLUSIONS OF LAW:

The Department prepared a corrected return for Retailers' Occupation Tax (hereinafter "ROT") liability pursuant to section 4 of the ROT Act (35 ILCS 120/4). Said section provides in pertinent part as follows:

> As soon as practicable after any return is filed, the Department shall examine such return and shall, if necessary, correct such return according to its best judgment and information. … In the event that the return is corrected for any reason other than a mathematical error, any return so corrected by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown therein.
>
> ***
>
> Proof of such correction by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy or computer print-out of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. … Such certified reproduced copy or computer print-out shall without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein.

In the case at bar, the taxpayer claims that the Department failed to use its best judgment and information in correcting its returns. Therefore, according to the taxpayer, the audit was not conducted with a minimum standard of reasonableness, and the Department has failed to make its prima facie case. The taxpayer also takes issue with the imposition of the fraud penalty, asserting it was neither authorized nor warranted based upon the facts herein.

As the taxpayer had no books and records to tender to the revenue auditor, Ms. "Madigan" had to use an alternative method to compute liability; the taxpayer acknowledges this fact. The taxpayer does not take issue with the specific method used

by the auditor; i.e., the purchase and mark-up method. The taxpayer even acknowledges that utilizing the methodology employed by the auditor, it does in fact owe some tax to the Department. Rather, the taxpayer takes issue with the price of draft and bottled beer assigned by the auditor to beer sales, insisting that this was not the best information available as there is no factual support for the prices utilized by the auditor.

Revenue Auditor "Madigan" assigned the price of $1.50 to individual sales of beer, whether by glass or bottle. She obtained the price of draft beer from the taxpayer at their initial meeting on October 21, 1997 at the Department's Des Plaines office. The auditor applied the price of draft beer to sales of bottled beer, as well. As the taxpayer did not maintain books and records or cash register receipts, or post prices, the auditor utilized the sales price suggested by the taxpayer.

Again, the taxpayer takes no issue with the method employed by the auditor in determining liability, i.e., applying sales price to units of draft beer, bottled beer and hard liquor purchases. It is the actual selling price utilized by the auditor that the taxpayer disputes. The taxpayer contends that even though the auditor was aware of "specials" offered by the taxpayer, she failed to consider them in assigning prices to draft and bottled beer. That is, the taxpayer advised the auditor regarding the specials, and showed her advertisements (many of which were undated) reflecting that on certain days draft and bottled beer was sold at a substantially reduced or "special" prices. As the auditor reflected in her audit narrative, however, the taxpayer never indicated the length of time that any of these specials ran. Not only did "Legree" never go into any detail regarding the special selling prices with the auditor, he most certainly never provided any documentation in the form of books and records indicating whether the specials were for

a limited time period on the days offered, or the entire time the bar was open. Neither did "Legree" ever proffer any documentation as to the number of bottles or draft beers sold on any given day, let alone on the days the specials ran. In and of themselves, the ads are not sufficient to alter the liability.

In the instant case it must ultimately be determined whether the Department established a prima facie case of liability. As the court stated in Masini v. Department of Revenue:

> establishing a prima facie case is concerned and the Illinois courts have uniformly sustained a prima facie case based
>
> statutory requirement that the Department substantiate the
>
> computed the corrected return in order to support its prima facie case. (Citations omitted). However, the Illinois
>
> question, the method employed by the Department in correcting a taxpayer's return must meet some minimum
>
> reasonableness standard is based upon the statutory provision which requires that the Department's corrected
>
> information. (60 Ill. App. 3d 11, 14).

Due to the lack of books and records, the auditor had to rely upon other evidence

best judgment and information, and a minimum standard of reasonableness in correcting "GI's" return. The taxpayer argues that the price the

particularly draft beer sales as they constitute the majority of sales, is incorrect. The auditor relied upon the taxpayer's statement that beer sold at $1.50 per glass or bottle.

Legree", she learned of his advertised

specials. It is unclear whether the auditor was shown these ads during the course of the

audit, or not until the end of the audit. Regardless, the ads from the Illinois Entertainer are not sufficient to make the determination that the auditor did not use the best available information in correcting the returns. Not all of the ads are dated, so it is not certain that they are relevant to the audit period. Furthermore, there is absolutely no evidence whatsoever as to the length of time the specials ran on any particular day, nor is there any evidence as to the amount of draft or bottled beer sold.

Given the lack of any evidence of price, it is my determination that the auditor used her best judgment, and the best information available (i.e., Mr. "Legree's" own statements) in correcting the returns and determining the tax due. The auditor utilized the limited information she had in a fair-minded manner. She surveyed taxpayer's suppliers to determine the amount purchased by the taxpayer for sale. She figured out how the purchases would translate to number of bottles or draft beers sold, applying the sale price to the number of units. Much later, when the taxpayer produced a limited amount of invoices, the auditor revised the tax liability to a lesser amount. As stated in Vitale v. Illinois Department of Revenue,

> This is all the law requires. (Citation omitted). To place a greater burden on the Department would reward the taxpayer for failing to keep the business records the law requires. (118 Ill. App. 3d 210, 213)

Thus, the prima facie case was established upon the admission into evidence of the corrected return.

The next question is whether the taxpayer rebutted the Department's prima facie case. The Vitale case, *supra*, sets forth well settled case law concerning what is necessary to overcome the Department's prima facie case:

> The taxpayer can overcome the Department's prima facie case merely by identified with the taxpayer's books and records, showing that the Department of Revenue's corrected returns are overcome the Department's prima facie case merely by denying the Department's case or by suggesting documentary evidence that the hypothetical weaknesses are relevant to this business. (Citation omitted). (118 Ill. App.

The taxpayer herein has challenged the corrected return, but has offered no documentary testimony regarding beer prices from two employees, it is unsubstantiated by competent evidence, is insufficient to rebut the Department's prima facie case of liability. (____ Barnes and Co. v. Department of Revenue st Dist. 1988).

Furthermore, the information contained in the report prepared by the Certified Public Accountant retained by taxpayer for this hearing was not derived from taxpayer's books and records, but rather, from distributor summaries, Illinois Entertainer ads and information derived from Mr. "Legree". It is, therefore, no more reliable or competent as evidence than the oral testimony from employees of "GI". The auditor relied upon distributor information, as well as information obtained directly from Mr. "Legree". As discussed previously, without any supporting evidence in the form of books and records, the ads are not sufficient to find that the liability as determined by the Department is not reasonable. It is my determination that the taxpayer has failed to rebut the Department's prima facie case.

The taxpayer also disputes the imposition of the fraud penalty. The taxpayer argues that the auditor did not have the authorization to impose the penalty at the time it was assessed. Written approval was not obtained until subsequent to the preparation of the corrected return. However, the auditor's history worksheet clearly indicates that she received verbal approval on March 25, 1998, while the corrected return whereon the fraud penalty was assessed is dated March 31, 1998. Certainly, this is a non-issue; verbal approval is sufficient to impose the fraud penalty.

In addition, the taxpayer challenges the basis of the fraud penalty. The auditor imposed the fraud penalty based upon several considerations, including taxpayer's failure to maintain books and records and make them available to the Department as mandated by statute and regulation. (*See*: 35 ILCS 120/7; 86 Ill. Admin. Code, ch. I, Sec. 130.801, 130.805). In addition, the huge disparity in gross receipts as reported, both originally and on the amended returns, with the amounts as determined by the Department is indicia of the taxpayer's intent to defraud the State of tax. Furthermore, "Legree", owner of "GI", concedes that he paid his employees cash straight out of the cash receipts drawer, thereby foregoing any deposit of that amount.

As stated in Vitale:

> [O]ur reviewing courts have determined that proof of fraud requires proof of the element of intent. (Citation omitted). Intent may be shown by circumstantial evidence. (Citation omitted). (118 Ill. App. 3d 210,213).

Certainly, in the instant case the circumstantial evidence is more than sufficient to indicate clearly and convincingly that fraud was present.

RECOMMENDATION

Based upon the foregoing, it is my determination that the Notice of Tax Liability at issue be affirmed in the amount as adjusted by the Department, and that the fraud

of the NTL.

Enter: February 28, 2000

Administrative Law Judge